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Building consensus on the future of the audit

This interview, Arnold Schilder, chairman of the International Auditing and Assurance Standards Board (IAASB), and Richard Balfour, PwC’s deputy global assurance leader, share their insights on the role of the audit, audit reporting and professional scepticism with PwC partner Dana Hiler.

Clarity on strategy delivers value for investors

Shanks Group plc set out to make its 2011 annual report compelling and not just compliant. Alison Thomas explains how the European waste management business got its message across and started winning reporting awards.

Effective reporting: it’s a matter of taking steps in the right direction

In this interview, Arnold Schilder, chairman of the International Auditing and Assurance Standards Board (IAASB), and Richard Balfour, PwC’s deputy global assurance leader, share their insights on the role of the audit, audit reporting and professional scepticism with PwC partner Dana Hiler.

Mandatory firm rotation – other changes would be better for investors

Objectivity, independence and professional scepticism are fundamental to audit quality, Don McGovern explains. Making it mandatory for audit firms to rotate would diminish audit quality.

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Companies have shown that the return on investment from focusing on sustainability can be impressive. Household names like M&S with its Plan A, Unilever with its Sustainable Living Plan and GE with Ecomagination have used sustainability to drive competitive advantage. Schemes such as these go further than clever marketing and deliver real value to the business. M&S’s Plan A delivered a net benefit to the bottom line of £105m in its last financial year and GE’s Ecomagination products generated revenue of £85bn from an investment of £1.8bn in research and development.

So why aren’t all companies following suit and reaping the same benefits? The question has led some to consider increasing the pressure on businesses to act on sustainability. And the issues will certainly be on the minds of world leaders, governments, the private sector, NGOs and other groups, this month as they come together at Rio+20, the United Nations Conference on Sustainable Development, to shape how we create a sustainable future on an ever more crowded planet (see page 32).

Paragraph 24 of the Rio+20 ‘Zero draft’ is getting a lot of attention at the moment. It states: “We call for a global policy framework requiring all listed and large private companies to consider sustainability issues and to integrate sustainability information within the reporting cycle.”

For some, this does not go far enough. A group of institutional investors (see page 30), with $2 trillion under management, is calling for an international commitment from Rio+20 to develop national regulations that mandate the integration of material sustainability issues in the annual report on a ‘comply or explain’ basis. Also, the World Business Council for Sustainable Development (a CEO-led organisation of forward-thinking companies) and the International Union for Conservation of Nature (the world’s oldest and largest global environmental organisation) have sent an open letter to the heads of delegations attending Rio+20 urging governments to strengthen paragraph 24 by including the explicit requirement for companies to adopt standardised, rules-based sustainability reporting. As we have seen, reporting is only an output and it is the actions companies take that is fundamentally the issue in driving more sustainable development activity.

If PwC’s recent CEO ‘pulse survey’ are anything to go by, it seems that business is not averse to a more prescriptive approach to sustainability reporting but they would welcome more certainty. But if the benefits are so great, why has a more prescriptive approach not already happened? One argument is that a prescriptive approach stifles innovation and moves everyone towards the lowest common denominator. If we are to respond to the threats posed by sustainability then we need more innovation not less, and arguably actions not words initially.

What is the best way forward? More companies doing a little, driven by ‘comply or explain’ type regulation? Or is it a case of some businesses breaking new ground because they see the commercial benefits? One thing seems clear – in the year of Rio+20, sustainability reporting is going to continue to rise up the political and business agenda, though organisations actions must come first and deliver real commercial, environmental and societal benefits. Reporting will follow.

Sustainability reporting likely to rise up the agenda

Opinions

In the following articles prominent experts discuss their views on reporting and assurance issues

Compelling reporting

How and why did Shanks make the change from ‘compliant’ to ‘compelling’?

See page 10

More insight from auditors?

IAASB chairman discusses the future of the audit with PwC

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ASSURANCE INTERVIEW

Building consensus on the future of audit

In this interview, Arnold Schilder, chairman of the International Auditing and Assurance Standards Board (the IAASB), and Richard Sexton, PwC deputy global assurance leader, share their insights with PwC partner and former IAASB deputy chair Diana Hillier.

What’s the role of the audit?
The future of auditing will inevitably be shaped by continuing fallout from the financial crisis. Changes to standards and new rules of engagement between auditors, companies, audit committees, shareholders and regulators are on the cards. Questions remain over the precise role of the audit as capital markets face new regulatory challenges.

How do you see the role of audit?
AS: I think audit plays an important role in establishing and increasing market confidence in companies’ financial reporting. So clearly the audit supports the quality of financial reporting. And auditors themselves add to this quality through their communications to board members and audit committees, as well as to the outside world.

RS: I agree, and the crisis has shown just how important audit work is in underpinning trust and providing insight. This is critical to the effective functioning of the capital markets.

What’s your vision for auditor reporting in five years’ time?
AS: Well, one thing’s for sure, it will be different from what it is now. We’re working very hard at the IAASB to produce a consultation paper in the middle of this year to invite comments on change.

RS: How we frame this question is critical. Investors are asking for more information. Some of that I’m sure will come from the auditors. I absolutely agree with Arnold’s sentiment that it’s time for some changes. But I think some of it may well come from the companies themselves. And getting that balance right is going to be a critical part of the debate over the next few months.

What sort of things do investors say they’d like to see in auditor reports?
AS: I’d say they want to understand more from the auditor’s perspective. How the auditors have assessed critical and highly relevant information in the financial statements and the disclosures. They want to know what’s important and understand the uncertainties and range of judgements that have been applied by management. And they want to know why the auditor agrees with them.

RS: We’ve been very clear in all our comments to the regulatory bodies that we have a fundamental principle: we believe the auditor should not be competing views of reality. But I’m not pessimistic – I don’t think that is what will happen. Think of the report that auditors take to an audit committee – you wouldn’t expect to see exactly the same perspective as they receive from management. What audit committee members like to hear is how you as auditors have assessed matters and what is critical for your judgement on the quality of management’s reporting.

Auditor reporting – more insight for stakeholders?
Perhaps the loudest demand for a change in auditing following the financial crisis is the call for change to the auditor’s report. The audit is a long and complex process and yet what’s visible to shareholders is a one-page report that includes one opinion and a lot of standard wording. Investors say they want auditors to provide greater insights, less standardised wording, and much more entity-specific information.

The future of audit supports the quality of financial reporting. And auditors themselves add to this quality through their communications to board members and audit committees, as well as to the outside world.
It’s clear that collaboration and cooperation between different players in the capital market systems are vital to ensure that we end up with solutions that are optimal for the capital markets as a whole.”

A AS: That’s a very good point and the one that we are wrestling with. What’s clear is that it has to be short, it has to be concise, and to some extent, it has to be unique compared to the previous year. But readers will not have the context, so that’s the challenge.

R S: Company management does have the opportunity to provide some of that context to complement the audit opinion. And the audit opinion is also there to complement the accounts – to express a view and to direct people to the most important aspects. These things need to work in harmony – we need to find a collective and collaborative solution.

A key driver behind the European Commission’s proposals for changes to the audit report was to reach a conclusion on going concern. Will we be able to achieve that in auditor reports?

AS: We’re working hard on it. We are exploring how to express an explicit conclusion rather than having an implicit one. But you need to explain a bit what the going concern assumption is all about, so that may need to be in the second part of the report.

RS: I think it’s key that we don’t lose sight of the fact that the auditor’s job is to provide an opinion on the accounts taken as a whole. Going concern is a really important element of that. The going concern question, as far as the auditor is concerned, is there to establish whether you should prepare the financial statements as a going concern or on a break-up basis. That’s a really fundamental decision. We have to be clear on the basis on which that assumption is made. But we mustn’t lose sight of the fact that the audit opinion is “an opinion on the accounts taken as a whole”.

Do you think that there will be any legal or regulatory impediments that might hinder our ability to make audit reporting effective?

AS: Regulation is part of life today, so we have to take that into account. But it should not stop us thinking about change. You would hope that the world would allow auditors to step forward and respond to what is being asked for without immediately being blocked by legal concerns. That would be a bit unfair, I think.

RS: There’s a huge energy and acceptance of the need to change on the part of the regulators, the auditors and companies. I think there will be some road bumps and there may be some blockages that we have to work around, but most of these obstacles can be dealt with.

It’s clear there is some very real energy and momentum around fundamental changes in auditor reporting. These changes will affect not only auditors but also the corporate sector and shareholders. It’s important that everyone gets involved in the debate to ensure we come out with a solution that meets expectations.

Do you believe auditors were lacking professional scepticism during the financial crisis?

AS: I am not an audit inspector, but of course I hear the comments and concerns expressed in many audit inspection reports. I think it’s not so much that auditors did not apply professional scepticism – it’s very explicitly in the auditing standards – it is that the world has changed. It has become more complex. When you compare auditing today with how it was in the past, then you see that people now have to ask more specific questions about underlying issues, alternatives and whether management teams have challenged themselves, their assumptions and how they have come to their judgements.

RS: And if you regard scepticism as fundamental, which I think everybody does, you bump up against the difficulty in demonstrating it after the event. It’s hard to evidence.

What is an appropriate level of scepticism in an audit?

AS: That is, of course, the ‘million dollar’ question. I think it’s a moving target because it’s related to what’s happening in the world itself and to the quality and complexity of financial reporting. It’s about asking the unasked and challenging the unchallenged. And it helps if you have documented how you intended to do that and what you and your team did to act on it. Whether that’s enough, well, we cannot be certain, but at least you can make the evidence more visible.

RS: There’s an issue about evidence of what you’ve challenged on and then, in real time, how you challenge. I don’t think anybody is suggesting that companies and their auditors have stand up fights over everything, but you can challenge in a sensitive way, testing the basis on which particular assumptions have been made and how conclusions have been reached. And it’s that challenge that I think people are rightly looking for, as well as for evidence of it.

How much of a challenge do auditors face in effectively documenting this approach in their working papers?

AS: Documentation is very important, in particular the conversations and discussions that the auditors have had with management and the board and the audit committees and how they have challenged each other. I think that’s a very powerful piece of evidence on applying scepticism.

RS: We’ve got to have the right mindset and linking that into the documentation is absolutely critical. I think this impacts not only the audit, but also the way companies think. There’s an important piece here about presenting the thought process you went through to get to the answer.

So as well as auditing standards dealing with required levels of documentation, should accounting standards be doing the very same thing in terms of management being able to demonstrate their thought processes in coming to their judgements?

AS: Absolutely.

Being very sceptical about everything takes you down the path of a more forensic type of audit as opposed to the audit designed to provide reasonable assurance. How do we find the boundary?

AS: I always remember a quote that I learnt from investors here in London: “What’s important is the soft stuff” – meaning the adjustments and uncertainties and the estimates where you have ranges of potential outcomes. I think that’s primarily where the boundary discussion should be. I think that’s also where board members and audit committees are more interested and where they have a role to play.

In summary, then, professional scepticism is core to the audit. It’s core to what auditors do and there’s been an increased focus on it following the financial crisis. Demonstrating the professional scepticism that’s actually been applied in practice is key, but keeping it front of mind as the audit is carried out is also vital.

This article is based on a filmed interview conducted by PwC partner Diana Hillier at PwC in May 2012. The video is available at:

www.pwc.com

Arnold Schilder
Chairman of the International Auditing and Assurance Standards Board

Richard Saxton
PwC deputy global assurance leader

Diana Hillier
PwC partner and former IAASSB deputy chair
What investors and analysts really want from corporate reporting is a consistent, coherent and realistic communication that helps them judge how well your company is tackling its challenges and exploiting market opportunities. No matter what industry they happen to be in, companies that are committed to improving their reporting by working hard on the narrative section of their report stand out from the crowd.

Shanks, one of Europe’s leading waste management businesses with operations in the Netherlands, Belgium, the UK and Canada, is a case in point. Its approach to making its 2011 annual report a key communications vehicle for the group holds valuable lessons for any company looking to meet investors’ information needs. According to Chris Surch, group finance director: “It starts from really understanding the purpose of an annual report. It is our platform for describing the company. It really is a key document.” Mr Surch and his team worked with PwC on ways of raising the report above pure compliance to give a deeper insight into the business. Shanks’ reporting team realised that what they took for granted about their market, wasn’t necessarily clear to others. So they put Shanks’ strategy in the context of a market overview section that explains the dynamics of a highly regulated industry characterised by changing legislation and tax incentives that are “forcing and encouraging everyone to think about recovering more resources from waste”. Shanks’ strategic focus on recycling and energy recovery (rather than landfill and mass incineration), for example, makes more sense when the increasing cost of landfill is explained.

How do you make money?

While working to improve the effectiveness of their reporting, the Shanks team quickly realised that they couldn’t assume knowledge of their business model. If you are a shareholder and new to the industry, you need to understand its dynamics and you need to understand the value creation process. In short, you need to know the answer to the question: how do you make money?

“Our business is about taking a tonne of waste and trying to minimise the amount that goes off to landfill,” said Mr Surch. “For us it’s simple to see how we derive value from that, but for others it was difficult because we had not explained it very well in the past. In most businesses, prices go up and volumes go down. In Shanks it is a little bit more complicated than that. People did not understand the interrelationships, so we thought we needed to explain it better.”

The challenge for companies is to give a clear picture of the business by providing just enough information to get the message across effectively without burying key messages and links in a welter of detail. Shanks decided to show how it makes money by taking the reader on a structured and clearly signposted tour of the dynamics of the waste management business, along with a clear articulation of the three legs of its business model. Management can drill down into areas where a newcomer to the industry might struggle. For example, Shanks offers descriptions of the technology processes it uses. This was not to indulge the ‘techies’ – it was a necessary step in explaining Shanks’ competitive edge in an increasingly high-tech business. And just to make things even more accessible to the lay reader, each technology and its associated industry terms and acronyms are explained on a single page and the processes are depicted in graphics that are themselves ‘recycled’ from investor and analyst presentations.

“We didn’t talk about commercially sensitive aspects of the business but we had to go the extra step in our explanations because there are no other businesses quite like ours for investors and potential investors to compare us to,” Mr Surch noted.

“We talked about external market drivers, which is all public domain information, and the internal drivers, which are management actions. But we focused on the interrelationships to help people get a better understanding.”

What about the risks?

Credible reporting depends on providing an honest and open analysis of opportunities and challenges facing the company. Investors are natural sceptics who quickly tire of reports that only focus on the positives. Sections that outline risks are therefore important.

Shanks acknowledges the importance of explaining its risk analysis by clearly categorising its main risk areas and explaining their potential to have an impact on the business. Its use of tables and charts in this section is an effective way of presenting the company’s approach.

“We are very clear about where there are pressures and where there are not,” said Mr Surch. “We spent a lot of time on the risks and opportunities section and people have found it very helpful. Some people might argue that you should avoid talking about risks and only talk about the good points. But our view has always been that it’s tough in any business and therefore you must set out the things that are going well and the things that are more challenging. It’s just not credible otherwise.”

How do you know that you’re on track?

Failure to link key performance indicators (KPIs) to company strategy is a common weakness in reporting. Just as strategic statements need to be set in the context of the company’s market environment, KPIs need to be presented so that the reader can assess whether the company’s game plan is on track.

Shanks sets the context for its financial and non-financial KPIs in terms of its business objectives and presents them clearly in tables. The management team has taken the unusual, but effective, step of quantifying targets for the returns it expects from its portfolio of projects. And it has repeated this approach across all its reporting outputs – including the annual report, its website and investor presentations. Setting out the company’s performance measures in this way helps to spell out the company’s investment potential. Just as important, it tends the message that management is confident and is in control of the business.

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**Effective reporting: it's a matter of taking steps in the right direction**

Investors inevitably want to know: Is a company performing as expected? What are the risks and opportunities for management? Mark O’Sullivan and Alison Thomas ask if clear answers are just a pipe dream

These are not questions that can be answered through intellectual discourse and debate. They require good hard data. And loss of it. Data that provides a鹏n understanding of the key financial and non-financial drivers of the business, including:

- Macro economic conditions and the pressures and the anticipated decline in activity are given in the country financial snapshots. These figures are in the middle range for the cost categories and are assumed to be the same going forward.
- Waterfall charts work well for finance directors and investors like them, too. Waterfall charts work well for finance directors and investors like them, too.

Chris Surch
Group finance director at Shanks Group plc

Alison Thomas
Corporate reporting director at PwC and a former investment analyst

Words and graphics work together to communicate the logic of the approach

The business model – how we make money. The drivers that influence the success of our business and deliver the business model are set out below.

<table>
<thead>
<tr>
<th>Gate Fees</th>
<th>Cost pressures</th>
<th>Recyclate prices</th>
<th>Volumes</th>
<th>Disposal costs</th>
<th>Cost savings</th>
<th>Investment strategy</th>
<th>Municipal strategy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market Share</td>
<td>Cost</td>
<td>Revenue</td>
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<td>£2.5m</td>
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<td>£2.7m</td>
<td>£0.1m</td>
<td>£2.9m</td>
<td>£0.2m</td>
</tr>
</tbody>
</table>

Source: Shanks Group plc Annual Report & Accounts 2011

Waterfall charts work well for finance directors and investors like them, too.

Know your target audience. If your business is highly leveraged, does your reporting meet the needs of the fixed income community? If you are looking to attract long-term shareholders, do you help potential investors understand why your company might be an interesting addition to their portfolio? If you are in an unusual or complex business do you help the reader to understand how they can be leveraged and to pose ‘what if’ questions about the future. This is the vision. But is it a pipe dream? We don’t think so.

Through our engagement with investors and with management over the years, we have identified a series of steps that can significantly improve the effectiveness of a company’s external reporting and provide a better platform for effective decision-making by management and the board. Some of these steps are simple, involve little if any cost and yet will be valued by the capital markets today.

Where are you starting from? It is difficult to make any sensible decisions about improvements if you are not quite sure where you are today. Before starting on any programme of change, benchmark your existing disclosures against investor needs and against your peers. That will help to prioritise and focus on really important issues that might require review of internal information systems, and so on.

**Where are you heading?** What information does management need for its effective decision-making? Understand the scope of data required and think about how you will want to use that data. Is it enough to receive print outs of reports from the various divisions? Or would you like data that you can easily pull into a ‘learning’ environment so that you understand better how the different business drivers interact?

Similarly, which type of investor would you like attract into your share ownership base. How can you provide them with the information that they need to forecast with confidence – to ensure that your company is given the valuation it deserves?

Don’t overlook the obvious… Time and again, investors tell us that management could significantly improve the usefulness of their corporate reports through very minor changes to existing disclosures. Look at the effectiveness of your GAAP disclosures. Is the information that is most useful to investors lost in a sea of boilerplate?

Is the information you provide credible and sufficiently reliable? Management take comfort in the fact that their financial statements have been through a rigorous process of review by external auditors. But industry-specific metrics and non-GAAP information that is not audited often move markets too. Investors tell us that they look for evidence that this information is reliable too.

Alison Thomas and Mark O’Sullivan
Corporate reporting directors at PwC
Mandatory firm rotation – other changes would be better for investors

Objectivity, independence and professional scepticism are fundamental to audit quality, Don McGovern explains. Making it mandatory for audit firms to rotate would diminish audit quality.

Why not mandatory firm rotation?

Mandatory audit firm rotation will reduce audit quality. There are more effective, less disruptive and less costly ways to reinforce independence. Effective safeguards are already in place and existing independence frameworks should be the foundation for any future improvements.

Looking for improvements

We agree that independence, objectivity and professional scepticism of auditors are at the heart of the audit profession. We should be looking for ways to improve independence safeguards and rules to increase investor confidence in the quality of our audits and companies’ financial reporting. We do not believe mandatory rotation serves those goals.

There is a striking lack of evidence to support the suggestion that mandatory rotation increases auditor independence and audit quality. In fact, it would have the opposite effect because:

- It reduces the quality of an audit. Mandatory rotation of audit firms would result in a significant loss of the auditor’s cumulative knowledge of the company’s business, people, processes, controls and risks – all to the detriment of audit quality. It also increases the risk of audit failures.

- It reduces audit committee effectiveness. Audit committees play a fundamental role in overseeing the audit and management’s relationship with the auditor. Mandatory audit firm rotation takes away the committee’s freedom to decide which audit firm best meets the needs of the company and its stakeholders.

- It reduces competition and restricts free market forces. Mandatory audit firm rotation artificially limits the freedom of those charged with governance to appoint the auditor that will best serve the interests of the company and its stakeholders. It also reduces competition in the audit market and may ultimately increase concentration rather than reduce it.

- It adds cost and complexity to audits. Changing auditors on an arbitrary schedule will be disruptive for both the company and the auditor. Any efficiencies achieved by, or lessons learned from, the previous auditors would be lost. And for multinationals, the need to appoint auditors around the world to comply with differing laws and regulations becomes even more complex.

- It goes against market consensus. Most countries don’t have mandatory rotation for audit firms. Some have considered it, but rejected it. Others have adopted it, but later reversed it.

The vast majority of those who have spoken publicly about the recent regulatory proposals, and a clear majority of audit committees, have said they don’t believe it is an effective way to achieve the ultimate goal.

What measures should be considered?

There are already many rules in place to safeguard independence that work well. But there are extra steps that could be taken to improve the perception of audit quality and independence in the eyes of our stakeholders. The measures below may already be in place in some territories but are not currently in widespread use.

- Strong, independent national regulators of the profession focusing on better coordination and communication between regulators, auditors and audit committees. More consistent inspection requirements for audit firms to drive higher quality and stricter oversight.

- Transparency about the audit and the auditors – such as: widening the scope of what auditors report to the audit committee about the audit process; better information from the audit committee to the public on its assessment of auditor performance and the basis of reappointment; and clearer communication by the audit firm with the public.

- Stronger governance by the audit committee – such as: regular mandatory assessment of auditors’ independence and objectivity; a formal audit committee charter to set out criteria for appointing auditors and for approving non-audit services; audit committee members competency requirements.

- Restrictions on non-audit services – such as: principles-based restrictions that reflect changing market needs rather than inflexible rules; and pre-approval by the audit committee.

Exploring new ways of enhancing independence and the broader matter of audit quality makes sense. On that point all can agree. But mandatory audit firm rotation is not the right way to do it. It may, in fact, have the opposite effect.
Governance reports should allay some concerns

The IFRS Foundation has finally released – a little later than planned – its strategy review alongside the Monitoring Board’s review of the Foundation’s governance. John Hitchins shares his view of the reports.

It seems the delay in publishing the reports was due to the Monitoring Board’s difficulties arriving at a consensus. The reports do not propose any radical change to IFRS governance. The current three-tier structure (the IASB being responsible for the technical quality of the standards, and the two oversight bodies ensuring independent standard setting and accountability) will continue. That seems sensible – it seems to be working. Some of the detail, though, points to changes of emphasis.

Both reviews have involved extensive consultation, and it is clear that commentators have been listened to carefully. The process should allay the concerns of those who have been critical of IASB governance in the past – or those whose concern is about the transparency of the governance rather than a disagreement with the technical content of the standards. This may help resolve one of the barriers to IFRS adoption cited in US roundtables on the subject.

The IFRS Foundation Trustees is similar to the October draft. The commitment to do more to promote consistency of IFRS interpretation across borders was widely supported, and this might be the biggest challenge for the IFRS community as it expands.

The enhanced role of the Due Process Oversight Committee is also important for building confidence in the standard-setting process among the sceptics.

Power to put topics on the agenda?
The Monitoring Board on the other hand has made a number of changes, backing off from what could have been seen as a dramatic extension of its role. Proposals that the Monitoring Board should be able to put topics directly onto the IASB agenda and should take a much greater role in appointing IASB members have been dropped. There are caveats though: if the Monitoring Board suggests an urgent topic that the IASB rejects, the IASB will have to give the reason why. Similarly, the Monitoring Board will be closely involved in the appointment process for a new chair.

Membership of the Monitoring Board looks like the area that probably had the most intense discussion. It will be expanded to include some emerging markets representatives, and two of the seats will be rotating – this in itself is uncontroversial. Membership will be restricted to capital markets authorities rather than expanded to include prudential and other regulators – a pragmatic decision, as it would be difficult to know where to stop.

Who will be allowed membership?
More significantly, members in future will have to come from countries where IFRS is required for domestic use. One can see the tensions here, and the elephant in the room is of course the US position – can one conclude that allowing use by foreign companies filing with the SEC amounts to ‘domestic’ use? On this, no doubt, there will be more.

The financing challenge
Finally, the most disappointing part of the reviews is the lack of a concrete proposal on the future funding of the IASB. Both boards agree there should be a transparent system whereby the jurisdictions using IFRS commit funds. The Monitoring Board says the trustees are primarily responsible; the trustees comment that they do not have the authority to mandate financing. At the same time, the trustees have indicated an aspiration to have a significantly expanded budget. This is perhaps the biggest collective challenge for the two oversight bodies to resolve.

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Almost 50%
can’t prevent or detect cybercrime, which is affecting costs and stakeholder trust
See page 22

Only 11%
of top Spanish companies align reporting information with their strategy
See page 26

We don’t understand!
Investors say tax reporting is incomprehensible but easily fixed
See page 34
Report shows little progress on board gender diversity

Achieving gender balance on the boards of EU listed companies remains a distant goal, according to a new European Commission report. Women represent 13.7% of board members across the EU, up from 10.8% in 2010 – a rate of increase that suggests it would take another 40 years to achieve equal representation.

The report, Women in economic decision-making in the EU, was published in March 2012, one year on from a call by EU Justice Commissioner Viviane Reding for publicly-listed companies in Europe to voluntarily increase the number of women in their boardrooms by signing the Woman on the board pledge for Europe. Companies signing the pledge commit to raising female representation on their boards to 30% by 2015 and 40% by 2020. To date, 24 countries have signed up.

The commission is considering possible action at EU level, including legislation and is expected to make a decision on further action later this year.

The report shows that 12 of the 27 EU Member States are currently ahead of the EU average of 13.7% of women on the boards of the largest listed companies. Only four countries are above 20% – France (22%), Sweden (25%), Latvia (26%) and Finland (27%). In the UK, which has the largest proportion of publicly-listed companies, only 16% of board members are women.

Pressure for legislation on gender balance is growing, with the report presenting survey results that show 75% of EU citizens in favour of legal measures to ensure results. France, Italy and Belgium introduced legislation in 2011 on board gender balance and are now using a quota system with sanctions for non-compliance. They are following the principle used by non-EU Norway, which introduced a 40% quota in 2003. The Netherlands introduced non-binding legislation in 2011 with a ‘comply or explain’ approach to reaching 30% balanced representation. Spanish legislation introduced in 2007 has a recommendation that 40% gender balance should be in place by 2007. Rules governing state-owned companies are in force in Austria, Denmark, Finland, Greece and Slovenia.

In the UK, a business-led approach to boardroom diversity is being promoted by both the government and the Financial Reporting Council. However, the government has stated it is prepared to introduce statutory quotas if necessary, (see World Watch, issue 3, 2011).

Shareholders to get binding vote on executive pay

Proposed major changes to the UK law on executive pay would give shareholders an annual binding vote on future remuneration policy, including proposed directors’ remuneration. Draft legislation is expected shortly following a consultation published by the UK government department for Business, Innovation and Skills (BIS) in March and April 2012. The regulations are scheduled to become law in May 2013.

Vince Cable, UK secretary of state for business, first announced the proposed changes in January in the context of calls for greater transparency on executive pay and increasing shareholder activism on the issue.

Described as the most significant recasting of the UK’s executive pay regime since disclosure legislation was introduced in 2002, the most significant aspects of the reforms likely to feature in the new legislation focus on a new model for shareholder voting, which includes:

- An annual binding vote on future remuneration policy
- Increasing the level of support required for votes on future remuneration policy, possibly up to 75% in favour
- An annual advisory vote on how remuneration policy has been implemented in the previous year
- A binding vote on exit payments over one year’s salary.

Earlier proposals unlikely to feature in the legislation include any requirement to have employee representatives on the remuneration committee and shareholders will not be represented on the nominations committee. Suggestions that companies should disclose the ratio of CEO to median employee pay and disclose pay arrangements below board level will also not feature in the new regime.

Based on our regular talks with institutional investors, we believe the current advisory vote on the remuneration report works quite well and we don’t think there is a strong case for a binding vote,” commented Sean O’Hare, reward partner at PwC in the UK. “Just how the vote is structured will be crucial and it’s important that it should be on high-level future policy rather than on the specifics of each director’s pay package. The board, through the remuneration committee, sets management pay, and this responsibility should not be given over to shareholders.

The proposed changes could lead to practical difficulties for companies, including four or five months of uncertainty over the structure of executive director incentive packages each financial year until the vote is taken at the annual general meeting,” O’Hare said. “The vote on exit payments could prove similarly impractical.”

“The focus has understandably been on boards, as they are visible, but the real sea change will only come when we focus on, and monitor, how diversity is encouraged in the middle management ranks of organisations. After all, we have to ‘grow our own’ so that they can then share their experience elsewhere.”

Sean O’Hare, PwC in the UK

“The binding vote may not actually empower shareholders – they may choose not to vote on remuneration policy if they fear a negative knock-on effect on the share price or board resignations. Requiring a 75% majority leaves the field open for minority shareholders to block the vote, which will lead to additional disruption for companies.”

Sean O’Hare, PwC in the UK
Corporate governance reforms extend ‘comply or explain’

The Hong Kong Stock Exchange (HKSE) has published its revised Code on Corporate Governance. The changes, which became effective in April this year, introduce greater adherence with the ‘comply or explain’ principle and bring issuers’ corporate governance standards more in line with international best practice.

The code maintains its three-tier structure of ‘Listing rules’, ‘Code Provisions’ and ‘Recommended best practice’. The majority of the proposals upgrade best practice and provisions and will require a ‘comply or explain’ approach in future. A small number of provisions have been made into rules. However, the exchange believes that most companies already comply with the provisions and so it does not expect them to find the additional requirements a burden.

The revisions include measures to:
- Improve transparency by bolstering requirements for disclosure and communication with shareholders
- Enhance the quality of directors and company secretaries by requiring training
- Require greater involvement in issuers’ board committees by independent non-executive directors (NEDs)
- Recognise company secretaries’ contribution to corporate governance and define their role and function
- Place emphasis on the leadership role of the chairman of the board in corporate governance matters.

One proposal that did not make it into the code – due to strong market opposition – was a rule or provision to limit the number of NED positions any individual may hold.

From April this year, listed companies must state in the first interim, half year or annual report that they have complied with the provisions in the revised code, as well as the previous one.

“It is pleasing to see the general direction the Stock Exchange is steering corporate governance,” said Keith Stephenson, PwC risk and control solutions partner in Hong Kong. “These proposals reinforce the value it places in good corporate governance. Many issuers have operations in China and this reinforcement of good practice is clearly welcomed.”

Executive pay survey highlights room for improvement

Compensation practices in Indian companies are becoming more mature and senior executive pay is on a par with global levels, but governance and performance links are lagging behind, according to a recent PwC report.

The report, Navigating the path to maturity, is based on a survey of 42 companies including industry leaders in a range of sectors with varied ownership patterns and listing status. Its findings show that senior executive pay typically now includes a 40% ‘pay-at-risk’ component, with an even split between short-term and long-term incentives. While the trend towards an increased pay-at-risk element is expected to continue, compensation for top people remains fixed-pay heavy and most companies still do not have robust measures in place to drive performance goals. However, equity-linked, long-term incentives are popular, despite a dormant stock market, indicating a welcome move away from short-term market fluctuations.

“Moving towards the next decade, the challenges that companies will face to optimise their compensation programmes will be many. Segmentation of rewards, and balancing between talent pressures and good governance will be key,” said Padmaja Alagananandan, PwC executive director in India.

An encouraging sign is that India has seen a move away from the ‘hiring at any cost’ concept following the economic crisis of 2008. The practice of offering long-term incentive plans focused on wealth creation and talent attraction are being replaced by an emphasis on sustainability of compensation costs and maintaining internal parity.

“Companies need to stay the course on their signed-off executive reward strategy, as flux in the pay framework is not a good thing for executives or shareholders,” said Ms Alagananandan.

The report highlights practices that show how Indian companies are learning from mature markets, including claw-back provisions in incentive plans that allow companies to recover bonuses in case of fraud or restatement of accounts. Indian companies are also steering clear of controversial ‘golden parachute’ incentive packages, although this may be by default rather than design.

Focus on board priorities

Directors at some of Russia’s top companies say their priority for the year ahead is to devote more time and attention to risk management, strategic planning and top management remuneration.

The Annual corporate director survey was conducted by PwC to analyse trends and priority activity for the boards of Russian companies. Respondents were predominantly non-executive directors (87%) with many of those (56%) representing companies with annual revenue of over US$1 billion. For context, the findings were compared with data from a similar survey in the US last year.

“In many ways the views from directors of Russian and US companies were on a par,” said Ms Alagananandan.

Similarly, only 13% of the directors surveyed gave the maximum score to the board’s ability to evaluate the performance of the company’s CEO, where US companies scored 48% for the same question. Nearly half of the Russian respondents said they wanted their boards to give more time to top management remuneration issues next year.

“I want more from board scrutiny of Russian and US companies,” said Alexander Chmel, PwC Russia, partner.

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Danger: cybercriminals at work

Cybercrime – however you define it – is having a growing impact on organisations’ costs and their ability to retain the trust of their stakeholders. Worryingly, almost half of respondents to a recent PwC survey said their organisation doesn’t have the capability to prevent and detect cybercrime.

Ten years ago, hardly any respondents to PwC’s Global economic crime survey knew what cybercrime was. But this year’s report ranks it as one of the top four economic crimes experienced in the last 12 months – just behind asset misappropriation (72%), accounting fraud (24%), and bribery and corruption (23%).

The 2011 Global economic crime survey considered the views of 3,877 respondents from organisations in 78 countries, with questions grouped into: general profiling, comparative (what economic crime organisations had experienced) and questions with a particular focus on cybercrime. Over half of respondents (52%) were senior executives, with 36% representing listed companies and 38% in organisations with more than 1,000 employees.

**Cybercrime on the rise**

The survey found that cybercrime is a growing threat. Almost half (48%) of those who had experienced economic crime in the last year said they perceive the risk of cybercrime to be on the rise. Only 4% think the risk is falling, with the rest thinking it will stay the same.

In the past, cybercrime was considered predominantly an external threat, but that perception is now changing, with organisations recognising the risk of cybercrime coming from inside. Of those, 53% believe there is a risk from the information technology department, but respondents are now recognising the threats posed by other departments like operations (39%), sales and marketing (34%) and finance (32%).

ECONOMIC CRIME

**Good practice guidance for accountants**

A new international good practice guide from the International Federation of Accountants (IFAC) aims to help accountants in business tackle common problems in internal control implementation and design.

Evaluating and improving internal control in organisations offers principles-based guidance on the business accountant’s role in maintaining effective internal control as an integral part of an organisation’s governance, risk management and internal control systems.

“Strong internal control is both one of the best defences against business failure, and an important driver of business performance. It mitigates risk and adds sustainable value,” said Roger Tabor, chair of IFAC’s Professional Accountants in Business (PAIB) Committee, which produced the guide.

Arguing for a focus on business performance and not just compliance, the guide encourages accountants to “create a cycle of continuous improvement for their internal control systems.” It offers guidance under nine key principles for evaluating and monitoring internal controls, chosen for their relevance to common implementation issues. “We looked at the sort of things that can go wrong with the way organisations apply internal controls, and drew out principles that professional accountants in business can apply to support their organisations in avoiding these problems,” said Mr Tabor.

**The key principles are:**

- Supporting the organisation’s objectives
- Determining roles and responsibilities
- Linking to individual performance
- Ensuring sufficient competency
- Supporting organisational culture
- Responding to risk
- Communicating regularly
- Monitoring and evaluating controls
- Providing for accountability and transparency

Issued as an exposure draft in December 2011, the guide has been generally well received. IFAC is incorporating suggested improvements and hopes to publish the final version in mid-2012.

Roger Tabor
Chair, Professional Accountants in Business Committee, IFAC

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Risk responsibility

When asked who should ultimately be responsible for dealing with cybercrime threats, 54% of respondents named the chief information officer (CIO) or technology director but only 21% opted for the CEO or the board. On that basis, it is hardly surprising that only 36% of respondents said the CEO and the board review these risks at least once a year, and almost a quarter said they only review them on an ad hoc basis.

“While it is clear that the CIO is usually responsible for IT security risks, we believe it is essential that the CEO and the board understand cybercrime risks and probe into them on a regular basis,” said PwC India partner Vidya Rajarao. “We think having a CEO who truly understands the risks and opportunities of the cyber world will be the ones to gain competitive advantage in today’s technology driven environment.”

www.pwc.com/crimesurvey

Concerns about Cybercrime

<table>
<thead>
<tr>
<th>Risk</th>
<th>% all respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reputational damage</td>
<td>40</td>
</tr>
<tr>
<td>Theft or loss of personal identification information</td>
<td>39</td>
</tr>
<tr>
<td>IP theft, including theft of data</td>
<td>35</td>
</tr>
<tr>
<td>Service disruption</td>
<td>34</td>
</tr>
<tr>
<td>Actual financial loss</td>
<td>31</td>
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<tr>
<td>Regulatory risk</td>
<td>28</td>
</tr>
<tr>
<td>Cost of investigation and change control</td>
<td>17</td>
</tr>
</tbody>
</table>

Source: PwC Global economic crime survey
Changes to governance and audit committee guidance

The UK Financial Reporting Council (FRC) has launched consultations on changes arising from its 2011 initiative, Effective company stewardship – enhancing corporate reporting and audit. Changes are proposed to the FRC UK Corporate Governance Code, the Guidance on Audit Committees and to a number of auditing standards. The FRC intends to implement these changes for reporting periods beginning on or after 1 October 2012.

Changes that the FRC previously consulted on, originating from the Davies report, Women on Boards, will also be included in the revised code but are not part of these consultations.

Proposals for the code and guidance

Boards would need to set out in the annual report the basis on which they consider the report to be fair, balanced and understandable, and provide the information necessary for users to assess the company’s performance, business model and strategy. The remit of the audit committee would be extended expressly to advise the board on this.

Audit committees would report to the board and in the annual report on:

- the significant issues considered in relation to the financial statements;
- their assessment of the effectiveness of the external audit process; and
- the length of time since the previous tender, which would spread the timing of FTSE 100 tenders across the ten years to 2022.

Companies would have to disclose the tenure of the incumbent auditor and the date when the audit was last put out to tender. The draft guidance recommends that companies indicate their intention to put the audit out to tender in the previous annual report, and that tenders should usually be conducted on an ‘open book basis’, where tendering firms have appropriate access to the incumbent audit firm’s audit strategy, risk assessments and audit approach.

Disclosures are also proposed around the identity of external board effectiveness reviewers, remuneration consultants and external consultants, together with any other connections they have with the company.

Proposals for auditing standards

The proposed changes to auditing standards are designed to support the new responsibilities for the board and the audit committee.

Auditors must also read the ‘other information’ in the annual report, under ISA (UK&I) 720, to identify anything that is incorrect or materially inconsistent with their knowledge.

Proposed changes also extend auditor reporting, under ISA (UK&I) 700 by requiring the auditor to report by exception:

- If the board’s statement of why the annual report is fair, balanced and understandable is inconsistent with the knowledge acquired by the auditor in the course of the audit.
- If the matters disclosed in the report from the audit committee do not appropriately address matters communicated by the auditor to the audit committee.
- If the other information in the annual report is apparently incorrect or materially inconsistent with the auditor’s knowledge.

There was previously no specific reporting requirement on auditors’ responsibilities to read the ‘other information’, other than for the directors’ report under the Companies Act.

Overlap with EU action?

In the consultation document on the changes to the code the FRC recognises that “there is the prospect of EU-level action that may overlap with some of the issues addressed in the code” and that some commentators have argued for changes to be deferred. However, it proposes to go ahead on the basis that “targeted and proportionate action to improve practice at national level may help to alleviate the pressure for more prescriptive action at EU level”.

In addition, to the EU proposals on audit reform, the US Public Company Accounting Oversight Board has been considering similar issues (see 41).

Greater disclosure but little insight under new code

South Africa’s top 100 companies may be putting quantity ahead of quality in their information disclosure under the republic’s new corporate governance code, which includes requirements for more ‘integrated’ reporting. A PwC report, analyses the practices of the Johannesburg Stock Exchange’s (JSE) top 100 companies in the period from 1 March 2011 – the second full reporting season following the King Report on Governance (King III).

The study found that JSE companies disclose large volumes of information but that much of it may not be material. Companies appear to be taking a broad-based approach without providing sufficient detail in important areas. However, most companies had improved both the quality and the level of disclosures provided compared to the prior reporting period.

“Integrated reporting”, a specific King III recommendation, represents a significant challenge for companies in the study, with most acknowledging that they are only starting out on an ongoing journey. King III looks for companies to “targeted and proportionate action to improve practice at national level in order to provide the necessary context for more prescriptive action at EU level”.

Three in four companies do not explain the key underlying external drivers for current and future growth.

All companies in the study include sustainability reports, and just over 60% had obtained assurance over the key elements of sustainability reporting. However, less than 40% of companies disclosed their sustainability strategies over the short, medium and long term. Responsibility for the integrated report and for sustainability reporting is not well disclosed by most companies – fewer than a quarter of reports indicate both the board and audit committee’s role in ensuring the integrity of the integrated report.

More than 90% of the companies report on directors’ remuneration, but only one-third meet the King III requirement to disclose the remuneration of the three top paid employees. Under half of the companies surveyed make the link between the remuneration policy and corporate strategic objectives.

Risk management is another area in which companies typically disclose information at a high level without providing real insight. More than 80% of companies disclose their key risks and risk mitigation approach, but fewer than 10% of entities disclose their risk appetite.

Almost three-quarters of all boards of directors accept responsibility for risk management, but fewer than half report on the effectiveness of risk management. Under 25% name their chief risk officer, and a minority of companies say how risk management is aligned with company strategy and integrated into its daily activities.

Zubair Wadies, PwC partner, commented: “While companies have made positive strides in moving towards integrated reporting, it has been an evolutionary rather than revolutionary process. There are clear leaders in this field of reporting who have embraced the concept wholeheartedly, whilst others are taking a more cautious and reactive approach, driven by what the leaders in this space are doing. Overall the effect is a positive one – reporting in South Africa is moving in the right direction.”

www.pwc.co.za
IBEX 35 trails FTSE 350 in integrated reporting

A new PwC study of the integrated reporting practices of Spain’s top listed companies shows they trail their UK peers in 10 out of 12 key areas of integrated reporting.

The survey, Integrated reporting in IBEX 35 entities, assesses how the IBEX 35 companies report on external market drivers, strategy and risks, resources, and performance and compares them with a similar study of FTSE 350 and FTSE 100 reporting practices.

More UK listed companies comment on future market trends than their Spanish counterparts (84% against 71%). However, the PwC analysis shows that three out of four companies in each jurisdiction fail to explain clearly how future scenarios could impact their business.

Most IBEX 35 companies (89%) include information on strategic priorities, which is on a par with the FTSE analysis (94%). But far fewer companies in each jurisdiction effectively align their information with company strategy (IBEX 11%, FTSE 16%). Spain is a little further behind in its reporting of key risks – 83% against 97%. The proportion of companies that clearly explain the impact of risks and their mitigation approach is again lower in each case – 31% in Spain and 45% in the UK.

Spanish companies lead the UK when it comes to reporting on their resource management (89% against 74%), but fare less well on explaining their business model. Less than 10% of the IBEX companies link resource management to their business model. 33% of FTSE companies explain their business model, which reflects the new UK Corporate Governance Code requirements.

Only 63% of IBEX 35 companies explicitly identify key performance indicators (KPIs) compared with 93% of FTSE companies. Less than 10% of Spanish listed companies make an effective link between KPIs and business strategy, against 35% in the UK. While sustainability KPIs are more prevalent in Spain – 97% against 74% – companies in both countries struggle to link sustainability with strategy.

“Current financial information looks to the past,” said Javier Lapastora, PwC assurance leader in Spain. “Today’s economic context demands a deep change to the corporate information model in the future, and no company should be reluctant to make this change if it wants to exceed the expectations of its stakeholders.”
Delays in UK mandatory carbon reporting decision

UK business is still waiting for a decision on mandatory carbon reporting, which was scheduled for introduction by 6 April 2012 under the Climate Change Act. The Department for Environment, Food and Rural Affairs (Defra) closed its consultation on options for carbon reporting last year. The Climate Change Act requires the environment secretary to introduce measures or explain why not, but as the deadline passed a report submitted to parliament stated that no decision had been reached. Business groups in favour of mandatory reporting claim that uncertainty over the policy is holding back investment in green jobs and technologies.

The Aldersgate Group, representing the views of prominent businesses and public bodies, stated its uncertainty over the policy is holding back investment in green jobs and technologies.

India’s top 100 listed companies must now submit Business Responsibility Reports along with their annual reports following a decision by the Securities and Exchange Board of India (SEBI) in November 2011. The new reports will set out how each company is acting in line with key corporate social responsibility principles set out in the National voluntary guidelines on social, environmental and economic responsibilities of business issued by the Ministry of Corporate Affairs (MCA) in July 2011. Areas that will need to be covered in the reporting include: corporate governance (ethics, transparency, accountability), product safety and sustainability, employee wellbeing, stakeholder relationships, human rights, environmental impact, responsible lobbying, inclusive growth and equitable development, and customer relations. SEBI says it will extend the requirement to other listed companies on a phased basis. www.aebib.gov.in www.mca.gov.in

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FRANCE

Law requires new CSR information

A new French regulation requires companies to provide assured information on corporate social responsibility (CSR).

French publicly-listed companies have been disclosing information in their management report on the human resources and environmental impacts of their activity since the NRE law in 2001. The recent Grenelle 2 law and its decree, finalised in April this year, introduce three new features.

First, the scope of the legislation has been widened to encompass larger non-listed companies that exceed certain threshold limits.

Second, the law defines the social and environmental information that needs to be provided, with a focus on information related to combating corruption and strengthening human rights. It also provides two lists of required disclosures, a standard list for non-listed companies and an extended one for listed companies. The scope of the new reporting is also defined – it should be aligned with the scope of consolidation for financial reporting purposes.

Finally, the CSR data, which will be part of the management report, will have to be certified by an independent third party who is appointed by the managing director or the chairman of the board for a period of six years. These new obligations are applicable from the 2012 reporting year for listed companies as well as non-listed companies with revenues over €1bn and more than 5,000 employees.

Other companies will have gradual application dates up to 2013 (and 2016 for the certification) to give them a little more time to get up to speed with the new regulation.

“The Grenelle 2 law is testimony to the greater significance now given to non-financial reporting by companies and their stakeholders,” said Eloise Fornas from PwC in France. “This new law gives companies an opportunity to rethink their internal reporting to better identify, value and manage the non-financial drivers of sustainable value creation and to work towards integrating their reporting so that it is more useful for strategic decision making, both by management and by external stakeholders.”

Towards integrated reporting

In the steps of the International Integrated Reporting Council, a French integrated reporting group has been set up under the sponsorship of the ORSE (the French study centre for corporate social responsibility). Companies, investors, accountants and CSR experts are all represented on the new body. It is chaired by former president of the French Order of Public Accountants Dominique Ledouble. It meets every month with the aim of sharing experiences and contributing to the international discussion.

Call for consistency in climate change reporting

Companies want greater consistency between existing climate change reporting frameworks rather than the development of a new global standard, according to an online survey by the Climate Disclosure Standards Board (CDSB).

The ongoing survey is collecting views on the challenges of climate change reporting from organisations of all sizes. Preliminary results were disclosed at an OECD Expert Workshop in February 2012. Full results are being presented at the United Nations Conference on Sustainable Development (Rio+’20) in June.

Most of the early respondents have an emission reduction strategy and use more than one carbon reporting framework, both mandatory and voluntary. Only one in four has carried out a cost-benefit analysis of greenhouse gas (GHG) measurement and reporting.

Key sources of inconsistencies between existing carbon reporting schemes stem from differences in formats, measurement methodologies and assurance requirements. Companies believe greater consistency could lead to savings on staff costs, verification and other external expertise. Intangible benefits include more credible information that is comparable with peers.

The GHG Protocol is seen as a sound basis for consistent reporting and companies believe more transparency is useful. However, some 25% believe that no new measures are required as there is a need for different schemes that are specific to their particular purposes.

Companies are generally in favour of aligning organisational boundaries in carbon and financial reporting.

The CDSB survey is online. www.cdsb.net

“Leading businesses are starting to rethink their business and reporting models around carbon and climate change. They are asking how can they drive sustainable, profitable growth, and how do they measure this critical information. Business is also looking for ways to report this transparently and consistently. The CDSB is taking a lead in trying to provide this clarity.”

Alan McGill
PwC sustainability and climate change partner
Finance models still hold centre stage for capital investment decisions

A recent study found that sustainability is a factor in companies’ capital investment decisions, but it is not yet a mainstream concern. New Australian research found that sustainability has an impact on one quarter of capital investment decisions.

While 94% of Australia’s top 100 companies (the G100) employ a sustainability manager, most do not have management systems in place to ensure that sustainability is factored into capital investment appraisals. Sustainability managers only provide input to ‘direct’ sustainability investments or when sustainability issues have already been identified in other potential capital investments.

The study, The influence and impact of sustainability issues on capital investment decisions, was carried out for CPA Australia (Certified practicing accountants) by the University of Melbourne. CFOs from a sample of the G100 along with sustainability managers took part.

Corporate reputation is the main reason for sustainability considerations to influence decisions. CFOs said that they consider how sustainability affects risk, competitive advantage, community relationships and employee engagement in these cases. A majority said they do not disregard qualitative data in favour of quantitative analysis and are more likely to be influenced by social rather than environmental factors. While 87% of CFOs said discounted cash flows are the best decision aid for all capital projects, some 40% said they would not necessarily reject a project with net present values where the case has been made for the sustainability benefits.

When sustainability managers are involved, it is usually in projects that involve direct investment in sustainable projects. In these cases the CFO considers different appraisal techniques and typically looks to the sustainability manager to provide a separate sustainability report. Some companies are experimenting with carbon costing and water accounting systems to feed into financial capital appraisals. But only one company in the sample used carbon costing as a separate line item to assess the effect on net present value in their capital appraisal process.

Investors call for material disclosures

A new investor grouping is calling for regulations to encourage listed and large private companies to integrate material sustainability issues in their annual reports. The Corporate Sustainability Reporting Coalition (CSRC) plans to submit a proposal to the Rio+20 summit in June to urge governments to back the development of a convention on corporate sustainability reporting.

While the CSRC favours a regulatory approach, it recognises the need to allow companies to explain to stakeholders why they do not believe they have any material sustainability issues to report. This would lead to the creation of a ‘comply or explain’ basis for sustainability reporting.

The CSRC represents investors with assets under management of approximately US$2 trillion, as well as other financial institutions, professional bodies, NGOs and other stakeholders.

The grouping was convened by Aviva, a global insurance and savings company. The CSRC proposal is consistent with paragraphs 24 and 104 of the Rio+20 Zero Draft that deal with greater corporate transparency.

Climate change taxonomy project

The Climate Disclosures Standard Board (CDSB) is working with XBRL to develop a taxonomy for disclosing climate change-related information. The project will produce a Climate Change Reporting Taxonomy (CCRT) that is compatible with the XBRL format used by an increasing number of regulators for electronic filing of statutory reports and other tax related filings.

The CDSB’s goal is to make climate change reporting and disclosure a more common feature of mainstream annual reporting, allowing stakeholders to assess a company’s ability to deal with the impacts and effects of climate change.

Will country-by-country reporting extend beyond extractive industries?

The European Commission’s original proposals for improved ‘corporate responsibility’ reporting included a requirement for enhanced disclosure on payments to governments by EU-listed or large private companies in the oil, gas, mining and logging industries. However, the European Parliament has broadened the scope of the proposal so that all companies with consolidated turnover over €500m would prepare a country-by-country report, rather than limiting it to the extractive and logging industries.

The parliament wants the disclosure to be part of the annual financial statements, rather than presented in a separate report.

This is being done under the transparency drive, to make large businesses more accountable for their actions and how they use scarce natural resources. It is also intended to shed light on how governments account for related tax payments. The current proposed date for it to come into national law is 1 July 2014.

The EU move echoes the US Dodd-Frank Act, which requires SEC registrants in the extractive industries to disclose, among other things, payments made to the US and foreign governments together with details of the projects involved. Concerns have been raised over the level of detail required under these proposals and the possibility that they may be extended to all multinational corporations.

Sustainability Reporting

In practice, what relative importance would you place on the following appraisal criteria for capital investments (other than regulatory)?

- Quantification of all social and environmental impacts: 9%
- Qualitative narrative (social impacts): 9%
- Financial return (ie, NPV, IRR etc): 48%
- Payback: 25%
- Other: 1%
- Qualitative narrative (environmental impacts): 8%

Source: CPA Australia

More corporate responsibility reporting is expected as part of the European Commission’s social business initiative

The current proposed date for it to come into national law is 1 July 2014.
Will the UN summit deliver on sustainable development?

In the second half of June, government ministers, business leaders, NGOs and the world’s press will converge on Rio de Janeiro for the 2012 UN Conference on Sustainable Development. Twenty years ago the Rio Conference on Environment and Development put climate change and biodiversity firmly on the global political agenda, so expectations for this year’s conference, Rio+20, are high. Will it deliver?

A ‘zero draft’ of the outcome document – The future we want – was released in January. The big themes are the institutional framework for sustainable development and green growth. Various issues are also on the table including sustainable energy for all, food security, sustainable agriculture and decent jobs. Subsequent negotiations have seen this expand to almost 200 pages and then cut back to less than 100, but we still appear to be some way away from final cut back to less than 100, but we still appear to be some way away from final. Will it deliver?

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The central issue of equity is a sticking point for many developing nations, so a meeting is to be held just before the conference to seek a broad consensus in advance of the conference itself.

CEOs rank importance of issues for their business now, and in 10 years’ time

<table>
<thead>
<tr>
<th>Issue</th>
<th>2012 Total important/very important</th>
<th>2012 Total important/very important</th>
</tr>
</thead>
<tbody>
<tr>
<td>Affordable Energy</td>
<td>87% (39% very important)</td>
<td>89% (60% very important)</td>
</tr>
<tr>
<td>Equality and social inclusion</td>
<td>83% (26% very important)</td>
<td>86% (43% very important)</td>
</tr>
<tr>
<td>Sustainable consumption and resource scarcity</td>
<td>80% (35% very important)</td>
<td>84% (31% very important)</td>
</tr>
<tr>
<td>Climate change</td>
<td>68% (25% very important)</td>
<td>78% (36% very important)</td>
</tr>
<tr>
<td>Water scarcity</td>
<td>65% (30% very important)</td>
<td>78% (38% very important)</td>
</tr>
<tr>
<td>Biodiversity loss</td>
<td>58% (12 very important)</td>
<td>64% (14% very important)</td>
</tr>
<tr>
<td>Food security</td>
<td>57% (28% very important)</td>
<td>63% (29% very important)</td>
</tr>
</tbody>
</table>

CEOs willing to take action

PwC conducted a ‘pulse survey’ of CEOs from around the world on expectations from Rio+20. Sustainability issues are expected to become increasingly important over the next ten years, with particular concerns about affordable energy and resource scarcity, but only a small minority of CEOs who responded to our survey expect significant progress on these issues at the conference.

Importantly, though, more than seven out of ten respondents said that their companies would be prepared to make more ambitious pledges to action on sustainability issues if there was significant progress on these issues at Rio+20.

“The Rio+20 summit can shape the vision and drive the ambition,” said Malcolm Preston, PwC global leader of sustainability and climate change. “But business has more confidence in ‘bottom up’ driven actions than it has in ‘top down’. Over 90% of CEOs signalled that regional or national regulation and fiscal measures, along with private sector investment, are the most effective mechanisms for driving investment and change.”

See also the editorial on page 4.

FSB task force focuses on year-end 2012

Investors, financial institutions and external auditors will be represented on a new financial institution risk disclosure task force set up by the Financial Stability Board (FSB). The move is part of the FSB’s focus on the effects on market confidence of effective communication by financial institutions of their risk exposure and risk management practices.

The task force will develop principles for improved disclosures based on current market conditions and risks, including ways to make disclosures more comparable across institutions. Its proposals are expected later this year in time for end-of-year 2012 annual reports.

The move follows an FSB roundtable meeting in December 2011 of 82 global, senior officials and experts representing the views of investors and analysts, asset managers, credit rating agencies, banks, insurance companies, audit firms, audit regulators, accounting and auditing standard setters, as well as prudential and market authorities. The meeting focussed on improving the transparency of financial instrument risks and risk management practices in risk disclosure through improvements to IFRS and US standards for disclosures covering financial instrument risks and valuations, off balance sheet exposures, and credit risk. Converged standards for disclosures about the gross and net exposures associated with derivatives and certain other financial instruments have also helped. While improvements have been made, the FSB meeting felt that more could be done to improve transparency. Similarly, the meeting welcomed moves by audit regulators to consider ways of expanding the risk-related reporting role of external auditors.

Key areas for enhanced qualitative and quantitative disclosure identified at the meeting will drive the task force agenda:

- Information on governance and risk management strategies
- Summary disclosure and comparability
- Credit risk and liquidity risk
- Capital adequacy and risk weighted assets (RWAs)
- Pillar 3 disclosure
- Scenario and sensitivity analyses

The task force will identify best practices in risk disclosure in 2011 annual reports, as part of its recommendations. It will also work with standard-setting bodies, such as the International Organisation of Securities Commissions, the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors, the IASB, FASB and the International Auditing and Assurance Standards Board.

The FSB plans to hold another international roundtable in late 2012 to assess progress towards improving the transparency of risks and risk management through relevant disclosures.

The FSB says that if follow-up actions by the private sector are lacking, international standard-setting bodies will be asked to take action.

Principles and examples of good practice risk reporting are available online.

References

www.financialstabilityboard.org
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Investors want better income tax disclosures

The income tax expense that companies incur can be significant – perhaps one third of the annual profits – but the tax information in the financial statements is one of the least understood areas of financial reporting, according to investors. Tax reporting reflects the tax liabilities that management expects to pay to the tax authorities; however, there is often a difference between the taxes paid and the charge made in the income statement.

“Feedback from our discussions with analysts on how companies report their tax indicates four key areas where they would like to see enhanced disclosures,” said PwC director Alison Thomas. “If companies can improve their reporting on tax rate reconciliation, expected timing of deferred tax reversals, cash tax and tax expense relating to unusual items, they will be well on the way to providing the investment community with the information they value for their investment decisions.”

Tax rate reconciliation

Some investors believe the tax rate reconciliation could be improved. Most group financial statements reconcile the annual tax expense to the parent company’s national tax rate. Many investors feel the geographical weighted tax rate of the group based on the profit split between the different territories in which it operates gives a meaningful number from which to start the reconciliation, as this would be the cash tax the group would expect to pay in the absence of any other adjustments.

Investors would also like to see better commentary on the many factors that can give rise to differences between the geographical weighted tax rate and the rate reported in the income statement.

Deferred tax reversal

Investors would welcome clearer explanation about the likely timing of reversals of the often significant deferred tax items on a company’s balance sheet, and the impact that would have on a company’s cash tax position.

Cash tax

Another area that is often not clear from the rate reconciliation is how the amount of tax actually paid by the company (cash tax) relates to the overall tax charge. Few financial statements reconcile to the cash tax position. However, disclosures could help clarify this position, including the likely timing of reversals, which would enable investors to adjust for the time value of money if they want to.

“Gathering the information to present this kind of disclosure may be complex,” admitted Dr Thomas. “However, it would give management the opportunity to provide more commentary around their deferred tax assets and liabilities, as they will be able to discuss the expected timing of the reversals and when they expect deferred tax to become cash tax.”

Tax expense in relation to unusual items

Financial statements are often silent on the treatment of unusual or one-off items despite these items often having a significant impact on the tax rate. Investors say more commentary would help. Management could also give more information on the comparable tax rates for prior years to demonstrate trends.

See also tax article on page 36. The Investor View series, can be found on the website.

www.corporatereporting.com

Revenue recognition: summary of responses to significant issues

Common themes

| Performance obligations satisfied over time | Respondents generally support the additional guidance but asked for clarity about how to apply the guidance in practice. |
| Presenting credit risk | Respondents generally disagree with the proposals and believe that credit risk should not be presented as an expense. |
| Time value of money | Respondents continue to express concern over the complexities and practical challenges of applying the guidance. |
| Variable consideration | Most respondents support the principle but want further clarity on how to apply the ‘reasonably assured’ constraint. Views are mixed on the sales-based royalty exception. |
| Onerous performance obligations | Most respondents continue to disagree with the proposals for assessing onerous performance obligations, citing that the accounting does not reflect the commercial substance in many arrangements. |
| Annual disclosures | Responders and respondents have split views on this topic. Responders have identified a number of disclosures that are not useful on the basis that they are not used to manage the business. Users support the proposals, saying that improvement to existing disclosures is crucial. |
| Interim disclosures | Most argue that the amendments to IAS 34, Interim financial reporting, are inconsistent with the principle that any significant changes from the last annual financial statements should be disclosed. |
| Transition | Preparers remain concerned about whether retrospective application would have cost-benefits, despite the relief offered by the boards. |

What’s next?

The comment period closed in March this year and the boards’ redeliberations began in June, with the final standard expected in early 2013. The effective date will be no earlier than 2015 but is likely to be 2016 or beyond, given the timetable and practical challenges of implementation.

This article first appeared in the May 2012 edition of IFRS news.

www.pwc.com/ ifrs

The IASB has delayed the effective date from 2013 to 2015 which will give companies time to apply all financial instruments’ changes together.

www.ifrs.org

Preparers, users and auditors have again provided feedback to the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) on their project, Revenue from contracts with customers. The volume of letters to this second exposure draft (ED) dropped significantly from those received on the 2010 ED. This could reflect the boards’ success in responding to many of the matters raised on the first ED.

The IASB and the FASB requested feedback on six areas, as well as general input about whether the proposed guidance was clear and operational. Many respondents did not restrict their comments to the six areas; as a result, some additional matters were identified that might warrant attention. Most respondents continue to support the boards’ efforts, but a number of concerns remain, including the accounting for onerous performance obligations, the extent of disclosures and transition.

The responses to some of the questions and other topics that attracted comment are explained in table.

www.corporatereporting.com
Review of segment rules

A new animal has been introduced into the standard-setting zoo: the post-implementation review. Although the IASB committed to undertake such reviews in November 2006, it is only now that the first one – a review of IFRS 8, Segments – is about to be carried out.

The review has two objectives. First, the staff will gather evidence to assess whether the standard achieved what it had intended to, bearing in mind the project’s objectives and the issues that were contentious while developing the new standard. The evidence will include both academic research and targeted outreach with users, national standard-setters or similar organisations.

Second, other issues will be identified, such as whether there have been significant implementation difficulties or unexpected costs associated with applying the standard. Next steps (if any) will also be proposed. This is important to help ensure a post-implementation review is more than just a backward-looking comparison with the previous standard. Rather, there should add value in the life-cycle of a standard, allowing it to improve further if needed. The board has agreed these next steps could involve: issues for referral to the IFRS Interpretations Committee; proposals for an IASB project; or proposals for improvements to standard-setting due process.

Some constituents have not waited to begin airing their concerns with the standard. The European Securities and Markets Authority (ESMA) has already issued a report on the implementation review of IFRS 8, in November 2011. The report discusses the application of IFRS 8 requirements by European issuers; explores the areas posing significant challenges to investors, preparers or enforcers; and makes recommendations.

ESMA concluded that the implementation of IFRS 8 resulted in a fairly similar level of information compared to its predecessor IAS 14, and that there is homogeneity in the issues faced by European enforcers. In their view, the issues stem from a combination of weaknesses in the standard and issuers’ failure to fully comply with its requirements.

Similarly, the Corporate Reporting User’s Forum (CRUF) has included segment reporting as one of their five ‘quick wins’ to improve an area where they believe financial statements are still not meeting the needs of the capital markets.

The views of ESMA and the CRUF will no doubt feed into the board’s post-implementation review process. A final report is expected by the end of 2012.

Enhancing transparency in the current environment

As challenging economic conditions continue for many countries, a policy statement from the Federation of European Accountants (FEE) is a useful reminder of some of the critical areas that must be communicated clearly by companies to avoid further loss of confidence. Top priorities for preparers of financial and non-financial information in the current environment include: measurement of assets, impairment of financial and non-financial assets, going concern issues and clear disclosures.

The FEE paper – Enhancing transparency and confidence – calls for consistent application of asset recognition and measurement principles as a prerequisite for reliable information. It warns that special care is needed over exposures to sovereign debt and receivables from entities in countries under financial stress. Preparers should assess any possible effects on future cash flows, and the FEE notes that smaller companies with cross-border trade may be particularly vulnerable. Proper application of the impairment principle, including the impairment of goodwill and other intangibles, is especially relevant in today’s climate.

Difficult market conditions mean that credit and liquidity risks and material uncertainties are more relevant today. With finance tight, FEE notes that management teams need to weigh both macro-economic and internal factors when assessing their entity’s prospects of continuing as a going concern. On disclosures, the FEE paper highlights the need to go beyond standard disclosures and provide greater transparency to help restore public confidence.

The FEE also discusses the auditor’s role and gives a reminder of the professional scepticism required to assess key risks and challenge management assumptions and estimates. Standard communication through the audit report is unlikely to meet public expectations for greater transparency, according to the paper. It stresses the importance of auditor communications with management boards, supervisory boards, audit committees and external stakeholders, including regulators. And it calls for “frank and open” dialogue between auditors and regulators, with the regulators playing “an increasing role in promoting as well as ensuring consistency and transparency”.

For the public sector, accelerating the move away from cash and towards accrual-based accounting will be a big step forward as it offers a better basis for understanding government economic activity at all levels, says the FEE. Public sector investment in internal controls and the involvement of independent auditors will also boost public and investor confidence both in the financial information and in government accountability.

Income tax paper: issues for debate

Areas where IAS 12 might be improved:
- Disclosures, including a more transparent tax rate reconciliation
- Measurement of income tax by considering whether deferred tax amounts should reflect the time value of money and be discounted
- Greater clarity about an entity’s uncertain tax position both through disclosure and measurement

Alternative approaches to income tax:
- Temporary difference approach
- Flow through approach
- Partial tax allocation approach
- Valuation adjustment approach
- An accruals or timing difference approach

Top priorities for preparers of financial and non-financial information in the current environment include: measurement of assets, impairment of financial and non-financial assets, going concern issues and clear disclosures.

www.fee.be
Board cautioned on agenda overload

The International Accounting Standards Board (IASB) met in January to review the key messages coming out of their agenda consultation, having received 245 letters expressing views on the board’s activities. The last ten years have seen significant change, with the emphasis on developing IFRS. Most now believe the emphasis should be on maintaining the standards. Respondents believe the previous agenda was far too ambitious and many cautioned the board to take no more than two to four standards-level projects on to the agenda at any time going forward.

There was also a general view that projects should only be taken on to the agenda where there were good reasons to believe that the capital markets would benefit from changes in accounting or reporting. Many thought more weight should be given to user-need research – citing surveys of users and post-implementation reviews as useful starting points for assessing whether change is necessary. Perhaps unsurprisingly, many respondents want the board to complete its four current projects (revenue, leases, financial instruments and insurance) as a priority.

There is a concern that convergence is still a main criterion for the board’s agenda-setting process. Many think that convergence is no longer a priority, and that the amount of change produced by the IASB’s joint programme with the US Financial Accounting Standards Board (FASB) has been excessive, leading to ‘standard-setting overload’ in many jurisdictions.

Many believe that the conceptual framework should also be a priority, and that a work plan targeting known issues such as the definition of an asset and liability could resolve some standards-level issues. This project should also address what ‘performance’ means by discussing other comprehensive income and performance reporting.

The board considered EFRAG’s arguments and acknowledged the concerns raised by some European constituents. But it noted that some companies have already committed resources to implementing the new standards and have requested that the original effective date should be retained.

The board gave particular weight to the fact that the new standards, particularly IFRS 10 and IFRS 12, are part of the response to the financial crisis and address matters raised by the G-20 and the Financial Stability Board. All board members voted to retain the mandatory 1 January 2013 effective date of the new standards.

The end of SA GAAP

South African national statements of Generally Accepted Accounting Practice (SA GAAP) are being withdrawn for financial years starting on or after 1 December 2012. Companies not currently applying SA GAAP and integral to the new SA IFRS must convert to reporting under IFRS in 2013.

South Africa began harmonising SA GAAP with IFRS in 2003 under the direction of the Accounting Practices Board (APB). As the APB issued IFRS standards unchanged as SA GAAP, withdrawing the national standards is seen as a way of avoiding duplication of effort.

The APB itself is being wound up and its functions will transfer to the Financial Reporting Standards Council (FRSC), established under the Companies Act in late 2011.

Final countdown to IFRS

Argentine listed companies are preparing to submit their first set of IFRS financial statements. Reconciliations have highlighted where key differences exist between Argentine GAAP and IFRS, and as the adoption date draws closer companies are focusing on their ability to fulfill all the disclosure requirements of IFRS – as well as embedding the new GAAP in their financial systems.

The National Securities Commission in Argentina (CNV) has worked closely with the accounting profession to adopt IFRS as issued by the International Accounting Standards Board (IASB) for most companies trading debt or equity instruments.

Plans to adopt IFRS were first announced in 2009. Since then listed companies have been providing progress reports on their conversion plans in their Argentine GAAP financial statements. Reconciliations filed in March this year have identified where differences exist between Argentine GAAP and IFRS (see box).

Some of the more controversial issues identified in the transition process include:

- Classification of preference shares as liability – from a legal perspective these are equity
- Determining the scope of IFRIC 12, Service concession arrangements, for utility companies – this led to CNV delaying adoption by a year
- Recognition of deferred tax liability for non-monetary assets – these are not recognised under Argentine GAAP
- Consolidation of some special purpose financing vehicles – some don’t meet the derecognition criteria in IFRS

To allow companies to revalue amounts, the CNV issued specific regulations requiring the engagement of independent appraisers and introduced the requirement for a detailed review by the board of directors covering the methodology used and the outcome of the revaluations.

The next step in the transition process will be for banks and insurance companies to be included in the IFRS fold. Argentina’s Central Bank has been moving in the direction of IFRS adoption and it is expected that full IFRS will be required for banks in the near future.

IFRS adoption challenges

In completing our review of the status of full convergence implementation, the ASC concluded that South Africa remains on track for full convergence, taking into consideration the progress of the IASB’s ongoing projects,” commented Michael Lim, chairman of the ASC. “The ASC is of the view that full convergence is not expected to result in significant cost and effort for Singapore listed companies that are currently using the IFRSs.”

Slowdown for IFRS convergence

The timeline for full convergence of the Singapore Financial Reporting Standards (IFRS) with International Financial Reporting Standards (IFRS) has been extended pending completion of several key projects on the international work programme.

The announcement came in March 2012, and followed a review of the status of full convergence for listed companies by the Accounting Standards Council (ASC) in Singapore. Original plans, set out in 2009, were for full convergence of the SFRS with IFRS by 2012.

In many ways SFRS are already closely aligned with IFRS. However, the ASC’s review identified some outstanding issues – such as revenue recognition and financial instruments—that will need to be resolved before full convergence can take place. These projects have attracted diverse comments as they progress and final standards are unlikely to evolve before 2015.
Clearer non-GAAP financial information sought

The Australian Securities and Investment Commission (ASIC) has issued a new regulatory guide on meaningful disclosure of non-IFRS financial information presented in company financial reports. This information is not prepared in accordance with accounting standards and offers an alternative view of a company’s financial performance. The ASIC guide aims to ensure that such information is not misleading to investors.

Non-IFRS information, including alternative profit measures, can be presented in company financial reports but only in line with specific legislative and accounting standards restrictions. ASIC’s view is that non-IFRS information should not appear on the face of the income statement but it can be included in the notes – such as the segment note – where permitted by accounting standards.

Companies have greater flexibility in the way they present non-IFRS information in other company publications such as directors’ reports, market announcements, investor briefings and transaction documents. ASIC recognises that investors use the information in these documents to help them get a fuller picture of the company’s overall position, business strategies and future prospects. However, variations in the way companies prepare and calculate figures such as non-IFRS profit information make it more difficult for investors to compare company performance.

The guide sets out four main requirements to help companies ensure that non-IFRS information does not mislead:

- Give at least equal prominence to IFRS financial information
- Explain how the non-IFRS information is calculated and reconcile it to the IFRS financial information
- Calculate the information consistently from period to period, and explain variations and adjustments clearly
- Present non-IFRS information in an unbiased way and do not use the information to remove or mitigate ‘bad news’.

ASIC Commissioner Michael Dwyer said: “Non-IFRS financial information can provide useful information to investors and other users of financial reports, however, it is important that information is not misleading. This ASIC guidance will be useful to stakeholders by providing guidance to assist in reducing the risk that information is misleading.”

www.asic.gov.au

Sprint finish for IFRS triggers implementation issues

A 10-year build up to introducing International Financial Reporting Standards (IFRS) in the Ukraine has climaxed in a race to adopt IFRS from 1 January 2012. Companies are sprinting to the finish line, with many unprepared for the practical implementation of IFRS.

A desire to become closer to the EU helped push the government to introduce a Strategy of IFRS implementation in 2007, but the adoption of IFRS was not formalised until 2011 in the Law on Accounting and Financial Reporting (the Law). The new law requires IFRS reporting for public joint-stock companies, banks, insurance companies and certain other entities. But the immediate introduction has given companies little time to prepare.

“IFRS adoption is a real challenge because transparency, comparability, and economic substance over legal form, are not part of the financial reporting culture in Ukraine,” said Bryan Disher, PwC assurance leader for Ukraine. “Some time for companies to study and understand the principles and begin to change their mindset would have been useful.”

However, he added that the adoption of IFRS is an important step in helping to improve investor confidence in Ukraine. The significant practical implementation issues for companies are being discussed at numerous round tables and public discussions. These include:

- Training – most companies have not yet trained their financial staff in IFRS so there is a high risk that initial IFRS accounts will be of poor quality.
- Systems – current accounting systems are not up to the task, so adoption in many cases will be via spreadsheets.
- Old and new accounts – the Ministry of Finance continues to require companies to prepare their accounts using old post-Soviet style statutory report formats, which are not fully compatible with IFRS financial statements.
- Transition date – companies can select a transition date, including 1 January 2012. The result might be some initial filings that do not include comparatives, but do include qualified opinions.

The US Public Company Accounting Oversight Board (PCAOB) received over 600 responses in its August 2011 ‘concept release’. They also held a two-day public roundtable in May this year to continue dialogue with stakeholders. In addition, there was a rather spirited debate in a hearing of a subcommittee of the US Senate Committee on Banking, Housing and Urban Affairs in early April.

The issue has evoked passion. Respondents to the concept release across all categories were overwhelmingly opposed to the idea. In fact, over 90% of responses expressed opposition. Similar sentiments were expressed by many of the panelists at the roundtable.

Audit committee members submitted the most responses; followed by preparers/issuers who were virtually all opposed. They pointed to increased costs, both for the audit and in management and audit committee time. Other reasons for opposing it included a perception that it would negatively affect audit quality due to the loss in institutional and industry knowledge; limit audit committees’ ability to choose auditors with appropriate specialization, geographic reach or industry knowledge; and inadvertently restrict the timing of business transactions or capital raising. Many pointed out that such complexities would be exacerbated for multinational companies.

The National Association of Corporate Directors (NACD), for example, which represents over 170,000 members, opposed mandatory firm rotation because of the impact it would have on the role of the audit committee and overall corporate governance.

Academics, investors and individuals who did not provide an affiliation had more support than other categories. But even among investors, 85% were opposed. Twenty out of 21 institutional investors were opposed, with the other neutral.

Reasons frequently cited in support of rotation included the advantage of bringing in a ‘fresh set of eyes’; avoiding relationships between auditors and clients that are too cozy; and an implicit incentive for auditors to be ‘on the ball’ and sceptical because they know that their work will be reviewed by another audit firm. Some also thought that increased competition would result in lower costs over time.

Alternatives to rotation?

If mandatory rotation is not the answer, what alternatives have been suggested that could enhance auditor independence, objectivity and scepticism?

- Strengthen audit committees, including enhanced audit committee reporting and interaction with audit inspection bodies
- More involvement of the audit committee in selecting the lead engagement partner
- Regulator right to effect rotation if audit quality/scepticism of an audit team is found significantly lacking
- Require audit committees to periodically re-evaluate the auditor relationship
- Mandate periodic retendering (which is also being considered in the UK).

See also the opinion article on page 14.

Little support for mandatory rotation

Mandatory rotation of auditors has been the focus of much debate in both Europe and the US. In the wake of the global financial crisis, it has been one of the solutions explored to enhance auditor independence and improve audit quality.
Using the work of internal auditors

The International Auditing and Assurance Standards Board (IAASB) has revised its standard on using the work of internal auditors. The new standard – ISA 610, *Using the work of internal auditors* – and the related revision to ISA 315, *Identifying and assessing the risks of material misstatements through understanding the entity and its environment*, come into effect for 2013 audits.

“Internal auditing standards and practices have continued to develop, as has the relationship between external and internal auditors. Equally, the expectations on the external auditor continue to evolve, particularly with recent heightened emphasis on audit quality and accountability,” said Professor Arnold Schilder, IAASB chairman. “Our standards must also evolve to take account of these changes.”

The changes are expected to strengthen the framework that enables auditors to evaluate and use internal auditors’ work when obtaining audit evidence. The revised ISA defines the conditions for using the internal audit function’s work – ensuring that the work is adequate for the audit, and preventing overuse or undue use of such work. The IAASB has approved new requirements and guidance that will put robust safeguards around the use of internal auditors. The new requirements and guidance will be published in the coming months.

One of the project objectives was to remove the ambiguity in the ISA about using internal auditors to provide direct assistance on the external audit. This proved quite controversial as some jurisdictions prohibit such use, and others worried that it might be unduly increased as a result of pressures on audit fees. The IAASB has approved this new requirement, and will release a report on the project in the coming months. The report will include a summary of the project objectives, the scope of the ISA, and a list of the key changes.

The new standard will reinforce today’s best practices. It is also expected to provide more guidance on the use of internal auditors, and to clarify concepts and make using the framework easier. Importantly, internal control concepts have been codified into principles and attributes. Those familiar with the original COSO framework will find much that is familiar in the proposed revision,” said Catherine Jourdan at PwC. “What’s new are enhancements designed to clarify concepts and make using the framework easier. Importantly, internal control concepts have been codified into principles and attributes.”

Other enhancements include setting out expectations for such areas as governance oversight; recognition of changes in business models; recognition of complexities in laws, rules, regulations, and standards; and expectations relating to preventing and detecting corruption.

Comments on the proposed framework and a companion executive summary are now being considered. A guide to applying the framework to internal control over external financial reporting is expected to be released for comment in the summer of 2012.

**Revision to framework on internal controls**

The US Committee of Sponsoring Organisations of the Treadway Commission – broadly known as COSO – is currently analysing comments received on the proposed substantive revisions to the COSO Framework. The original framework has been widely used around the world for designing, implementing and evaluating the effectiveness of internal control. The company and auditor reporting requirements on internal control, implemented under the US Sarbanes-Oxley Act, cemented its importance in practice.

The original framework was created nearly 20 years ago. Since then, business and operating environments have changed dramatically. They have become more complex, technologically driven and more global in scope. Stakeholders have also become more engaged and look for transparency about entities’ systems of internal control, not only around an entity’s financial reporting, but also around its business decisions and corporate governance.

The proposed new framework has retained the core definition of internal control and the five components of a system of internal control – control environment, risk assessment, control activities, information and communication, and monitoring activities. Both frameworks also emphasise the importance of judgement in designing and evaluating the effectiveness of a system of internal control.

The FSB urges enhanced role for external audit

The Financial Stability Board (FSB) has backed efforts by international supervisory bodies and regulators to strengthen the role of external audit in financial stability. At its January 2012 meeting, the FSB highlighted international and national initiatives currently under way to improve audit quality and regulation and the information that external audits provide to prudential supervisors and regulators of financial institutions.

The FSB called on the International Forum of Independent Audit Regulators (IFIAR) to report on the issues identified by its members in their inspections of financial institutions’ external audits, including the audits of systemically important financial institutions (SIFIs). Information on IFIAR members’ responses to key issues and their recommendations for strengthening external audits will help make audit regulation more effective and improve audit quality, according to the FSB.

Key initiatives highlighted for input by the FSB include the Basel Committee’s proposals for new robust external audit guidance, expected by the end of 2012, and work by the International Association of Insurance Supervisors on external audits of insurance companies. The FSB is working closely with the International Organisation of Securities Commissions (IOSCO), which is monitoring the efforts of the International Audit and Assurance Standards Board (IAASB) and national standard setters. FSB members are also providing input to the World Bank’s review of how to enhance its Accounting and Auditing Reports on Standards and Codes (ROSC).

■ www.financialstabilityboard.org

■ www.coso.org

■ www.iiasb.org

■ www.ifiac.org/auditing-assurance

■ www.iasb.org/audit-quality

■ www.icsa.org.uk

■ http://www.ifiac.org/auditing-assurance
Collaboration needed to improve usefulness of disclosures

Solving the problem of how to promote the quality of financial reporting disclosures will need a collaborative response from stakeholders, according to respondents to a discussion paper from the International Auditing and Assurance Standards Board (IAASB).

The paper, The evolving nature of financial reporting: Disclosure and its audit implications, was issued in 2011 (see p39 World Watch issue 2, 2011), with the feedback statement published in January 2012.

The feedback statement summarises the key messages from a wide range of stakeholders. The majority of respondents believe strongly that the IAASB needs to collaborate with financial reporting standard setters, including the International Accounting Standards Board (IASB), alongside securities, audit and prudential regulators, preparers and investors to address issues around disclosures. In particular, they highlighted materiality as an example of where progress can – in their view – only be achieved through collaboration.

Other significant challenges expressed by participants include: the impact of trends in financial reporting; evaluating misstatements generated by disclosures; the availability of audit evidence to support disclosures; and work effort. To address some of these issues identified, respondents called for more auditing guidance in certain areas.

Ms Lord, added: “Perhaps the most important aspect of this report was exploring the appropriate balance between cooperation and challenge. Trust and cooperation are essential to foster an environment in which issues can be discussed robustly and decisions challenged in constructive ways.”

“Financial information that is reliable, understandable, and relevant is essential – as is the assurance on that information that auditors provide. We wholeheartedly agree with the respondents regarding the need for international collaboration and cooperation... We must work together to develop effective responses to the issues being faced today.

“Like others, the IAASB has a role in enhancing the public’s confidence in disclosures as a priority – recognising that individual initiatives must be towards finding a collective solution.”

James Gunn
IAASB technical director

UK

Call for audit committee debates to be more transparent

Bank annual reports should include details of the key accounting judgements that have been challenged by the audit committee, according to a new report from the Institute of Chartered Accountants in England and Wales (ICAEW). The report calls for greater transparency on the challenge and debate between bank auditors, the audit committee and executive management as a route to promoting better dialogue between stakeholders and inspiring confidence in financial services following the banking crisis.

Enhancing the dialogue between bank auditors and audit committees points out that much of the bank audit process takes place behind closed doors. Lack of transparency has raised questions over the extent of professional scepticism being applied in the banking sector.

The report’s practical recommendations cover actions to balance the level of cooperation and challenge between the auditor, audit committee and executive management during the annual reporting process.

Forward planning is essential to ensure an efficient year-end process and to allow time for effective challenge and debate.

Gilly Lord, the report’s author and PwC partner comments: “In the tripartite relationship between auditor, audit committee and executive management, there are times when close cooperation is important, but other points where we should expect healthy debate and challenge. A good dialogue recognises and values both elements.”

Iain Coke, Head of ICAEW’s Financial Services Faculty, said: “Nowhere is good and transparent governance more important at the moment than in banks. Public confidence has been damaged and must be re-built. Clear reporting, robust auditing and transparent governance processes are all critical elements for that to happen.

For rigorous challenge to take place in an open way, the relationships must balance cooperation and challenge, be based upon trust while underpinned by professional scepticism. Auditors must tell a full, clear story of the audit to audit committees, while audit committees, in turn, must tell their own story to the public to provide confidence in the governance process.”
Today boards and audit committees expect more from internal audit. They want internal auditors to act as their eyes and ears and provide essential comfort that all critical business risks are being well managed. But the challenge for the chief audit executive (CAE) is to find a way to consistently deliver on these increasing expectations.

These opinions were expressed by 1,530 CAEs, audit committee chairs, CEOs, CFOs and other stakeholders from around the world. Their views are shared in PwC’s 2012 State of the internal audit profession study.

This was the first year the annual study took an ‘outside in’ look at the internal audit profession, with other company executives invited to comment on internal audit’s role in their organisation and its capabilities for supporting the risk management activities of the company.

**Risk management**

Only 45% of respondents think the majority of their company’s critical risks are being well managed, despite acknowledgement that risks are becoming more complex, less predictable and more diverse. Organisations with financial performance above their peers expressed an average confidence level of 53% across the top 15 risks. By comparison, only 25% of companies that perform financially below their peers believe they manage the same risks well.

The survey found six areas of risk with a pronounce disparity between internal auditors’ views and the perceptions of their stakeholders in the business (see chart).

Misalignment in either direction can mean that internal audit does not adequately focus on the risks that are most critical to the organisation. One of the greatest divergences, for example, was within management of risks associated with fraud and ethics, where 53% of stakeholders felt confident in their organisation’s management of risks, compared to only 35% of CAEs. Confidence around risks associated with mergers, acquisitions, and joint ventures showed a similar diverging viewpoint, with 50% of stakeholders expressing confidence, compared to 33% of CAEs.

**Overcoming the barriers**

Stakeholders and CAEs identified organisational and cultural resistance (57% of respondents), coupled with a lack of internal audit resources and expertise as common barriers to meeting stakeholders’ heightened expectations.

A clear talent development strategy, rotation of staff with the business and effective use of co-sourcing were cited by respondents as the best ways to address resourcing and gaps in expertise.

“Our survey confirms that boards and audit committees expect more from internal audit,” said John Feely, PwC global internal audit services leader. “To add to stakeholder confidence and be seen as a vital, contributing business partner, internal audit must do much more than financial controls and compliance – it needs to provide assurance across a broader range of business risks, provide deep insights and business perspectives and be able to present to stakeholders in a way that cuts through the clutter.”

**Cut the communication clutter**

Company executives believe internal audit pays too little attention to the majority of risks. They want internal audit to adopt a dynamic, top-down risk assessment and planning approach that addresses all critical risks across the company. And they want it presented in a way they can easily digest and then contribute to planning. At the same time, company stakeholders want internal audit to present factual assurance about risk management activities and trends in a succinct, easy to understand way – they are looking for assurance with insight.

“CAEs and the company stakeholders we interviewed said that simplifying the message for the audit committee has become very important – this helps to ensure that risks are well understood and their potential impacts clearly communicated.”

John Feely
PwC global internal audit services leader
# Diary dates

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<td>Rio+20 Conference on Sustainable Development</td>
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<tr>
<td>25-27 June 2012</td>
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<td>27-28 June 2012</td>
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<td>28-30 June 2012</td>
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<td>6 July 2012</td>
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<td>12 July 2012</td>
<td>IFRS Foundation Trustees Meeting</td>
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<td>12 September 2012</td>
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<td>18-19 September 2012</td>
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<td>12 October 2012</td>
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<td>21-23 October 2012</td>
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<td>25-26 October 2012</td>
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